August 8, 2018

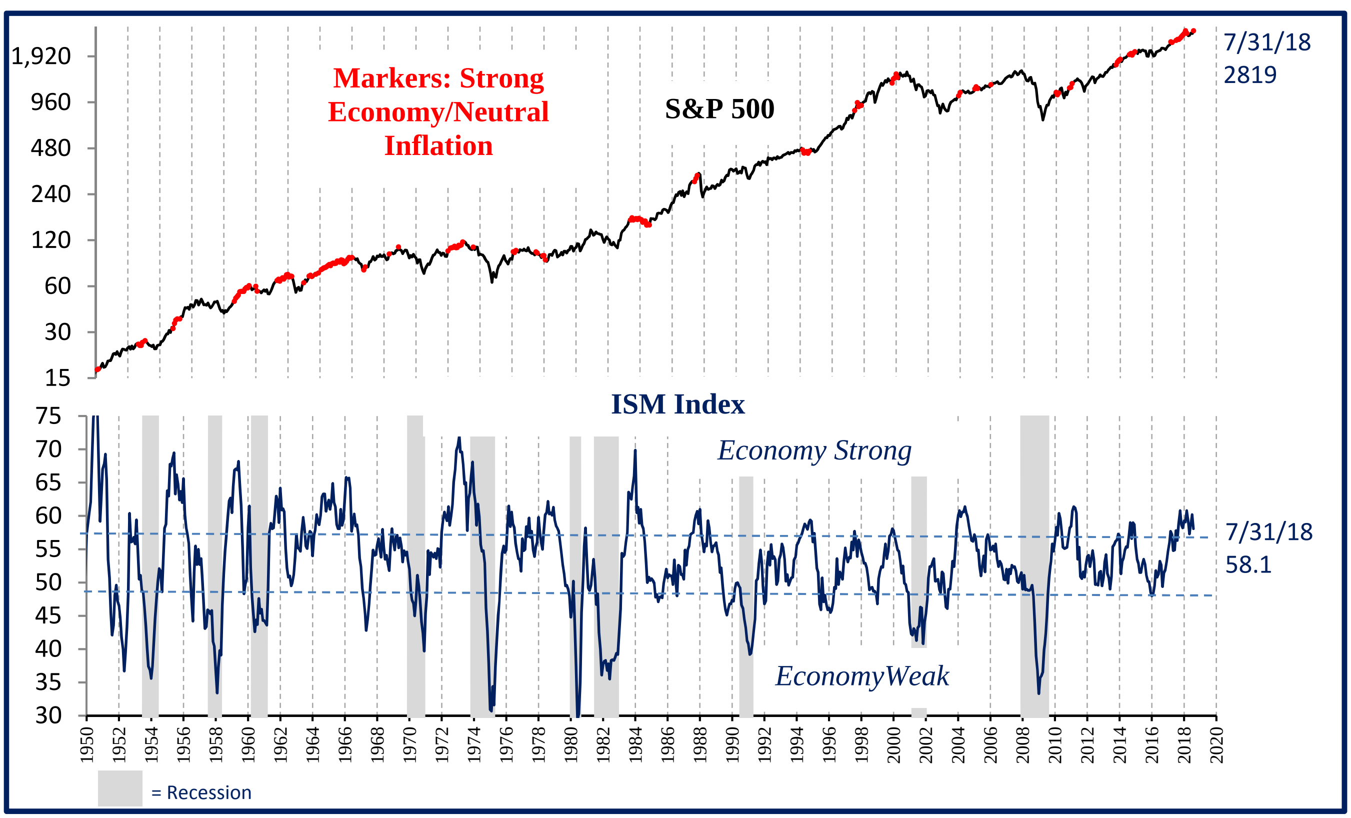
Economic Conditions: Bullish for Stocks

The equity rating remains a bullish 5. Despite headwinds, like historical weakness in the months of August and September, positive indicators dominate. For instance, sentiment readings are surprisingly only mixed, with 5 of 9 investor groups showing pessimism. Recent volatility in technology stocks, like the 20% Facebook decline last month, has exemplified this “wall of worry”. Continued trade war headlines have also contributed to the mixed investor sentiment. All of this may actually extend the economic cycle. Our ratings on long-term bonds, commodities and gold also remain unchanged.

The ISM manufacturing index remains strong--in the top 20% of historical readings--but it declined 2 points in July. Of the 30 foreign economies we track, 75% also down ticked. This confirmed our July report, which showed that historically, when emerging markets declined, a slower economy followed. More significantly, the inflation component of the U.S. report decreased as well, falling into the neutral zone below 75.

Although equity investors worry about a slowing economy, current conditions are bullish for the S&P 500. Since 1950, the S&P returned a consistent 16.9% annualized when the ISM inflation gauge was neutral and the overall ISM index was still positive over 56. The biggest risk to stocks in the boom phase is inflation, since it can lead to a recession through aggressive Fed tightening and often an inverted yield curve. The silver lining of the trade war could be an extension of this economic cycle by delaying inflation. You can see on the chart that longer periods of strength without inflation were normal prior to 1970. In those cases stocks rallied as they have recently.

ISM Manufacturing Index: Strong Economy + Neutral Inflation = Bullish for Stocks



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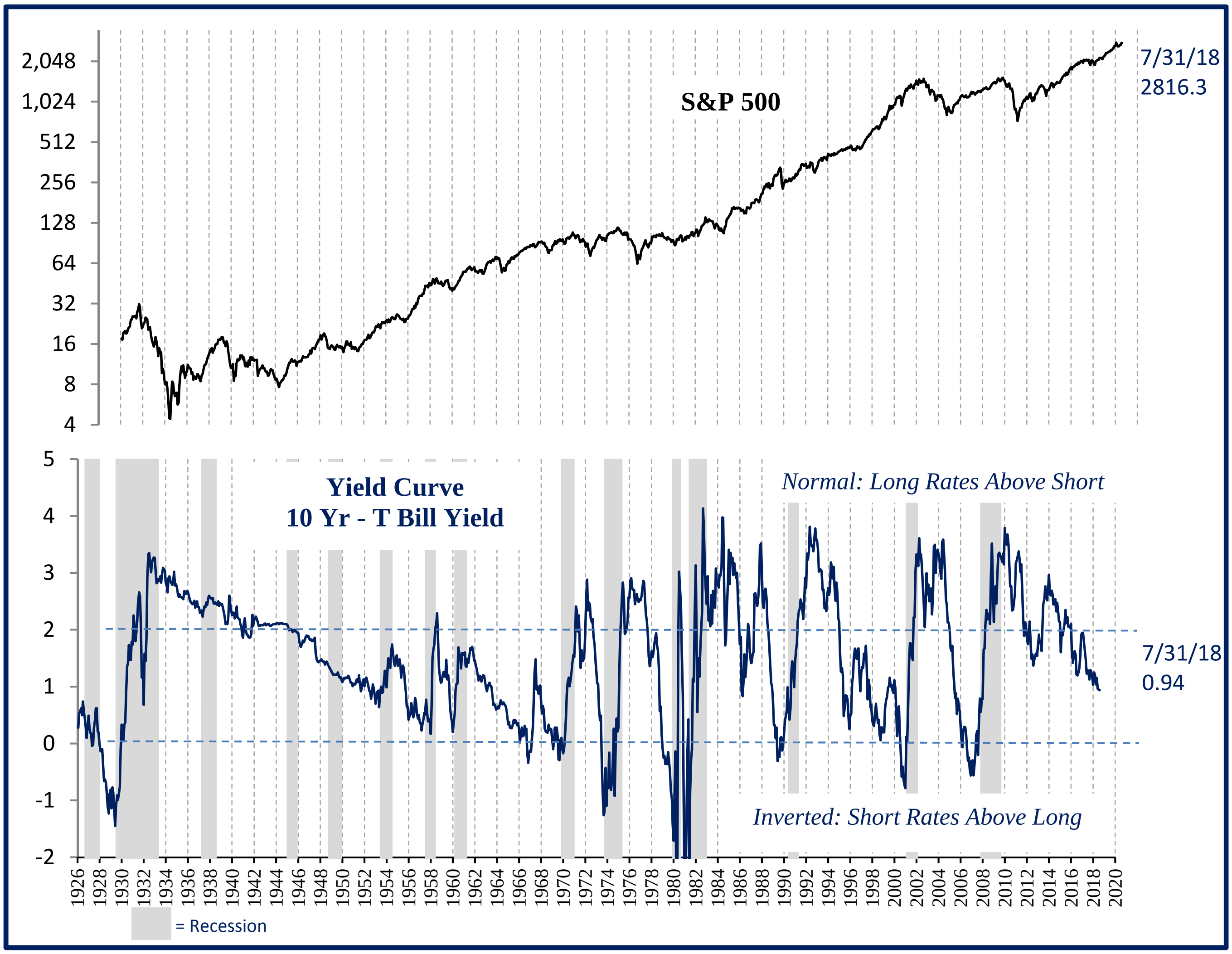
Yield Curve Indicator: No Signal

The yield curve is the difference between short and long-term interest rates. Normally long-term rates are higher than short-term rates to compensate investors for the greater duration risk, also called the term premium. However, when the Fed hikes rates aggressively, they can push short-term rates above long-term rates, which is called an inverted yield curve. You can see in the chart that in the 8 yield curve inversions since 1926, a recession followed every time. Despite all the recent press about the yield curve, there is no inversion and therefore no meaningful signal at this time. There were 7 recessions without an inversion, so a normal curve is no guarantee for the economy.

Yield Curve as a Recession Indicator 1926 - 2018



Although conditions are bullish for equities, we expect normal volatility, which typically includes 3%-5% declines.

Michael Schaus
Director of Market Research

August 8, 2018

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